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First National City Bank
Monthly Letter
Business and Economic Conditions

New York, October, 1958

General Business Conditions

THE business recovery is continuing at a good pace and on a broad front. Preliminary reports for September indicate that production and sales have risen further. The Ford labor contract has encouraged hopes that a prolonged auto strike, with widespread effects on business generally, may be averted – to be sure at the cost of increased wages and prices. Particularly encouraging is the month's news from the capital goods industries. These industries are the laggards in the upturn, and, during the summer, while most business indexes were rising sharply, optimism was tempered by fear that the decline in capital expenditures had much further to go and would exert a prolonged depressing influence. Latest evidence, however, is that the drop in this key area has already bottomed out. No great rise is in sight, but even a sideways movement is a help.

Preliminary estimates show both personal income and personal consumption at new records during the third quarter, while economic activity generally – as measured by gross national product – appears to have recovered roughly two thirds of the ground lost during the recession. The persistent rise in prices, inflating dollar figures, causes them to understate the decline and overstate the rise in real terms, but, even after allowing for inflation, the gains are significant.

More than one half of the decline in the physical volume of industrial production was regained in the first four months of recovery. Between April and August, the Federal Reserve index (seasonally adjusted, 1947-49 = 100) rose from a low of 126 to 137, making up 11 points of the preceding 20-point decline. The sharpest drop in output during the postwar period is thus being followed by the sharpest recovery. The problem now is how long the present speedy rate of recovery can be maintained.

The Nature of the Recovery

Four influences stand out as dominant in this rapid upsurge: shifting inventory and purchasing policies, strong consumer demand, heavy government buying, and an upswing in home building.

The liquidation of inventories has been sharper and deeper than in previous postwar recessions. By late spring, stocks of purchased materials in many lines started to get uncomfortably low. Ordering picked up. As business in general improved, buying accelerated.

In steel, for example, the drop of 38 per cent in mill operations far outstripped the most pessimistic estimates of the decline in actual steel consumption, as steel users drew heavily on accumulated inventories. Conversely, from April through August, while steel usage increased only slightly, output rebounded more than one fourth, as the share of steel drawn from existing inventories dwindled and the share from current shipments increased. By late September, steel production and consumption were estimated to be roughly in balance.

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The same thing is happening in other industries. The shift from a record rate of inventory liquidation in the first quarter of this year to a condition of approximate stability seems likely to be completed in the near future. Over all, it will have increased the demand on producers by $9½ billion. This, however, is a temporary stimulus. Continuing recovery will require improved demand from final consumers.

Strengthening Consumer Demand

With individual incomes bolstered by rising government outlays, spending on services increased all through the recession, while expenditures on goods stayed close to previous records. The chief exception was automobile demand. Dollar outlays for autos and parts dropped 22 per cent between the third quarter of 1957 and the second quarter of 1958, while expenditures for other consumer goods dipped only 1½ per cent. Consumer buying, except for autos, appears to be reaching a new peak in the third quarter, with both durable and nondurable goods sharing in the rise. Behind this increased consumer spending are the upturn in private payrolls, growing confidence, the optimism fostered by rising stock prices, and, to a lesser extent, the windfall payment of retroactive salary increases to Government workers.

Steadily rising retail sales helped expand nondurable goods production to a new record in August. During the summer, paper, apparel, processed foods, and tobacco products exceeded their 1957 production peaks, while textile output recovered sharply after a prolonged slump. Rising demand for appliances touched off an increase of one fourth in production of consumer household durable goods from their April low.

Government as a Big Buyer

Government spending has risen and so have government orders, which are reflected in inventories and productive activity long before the finished goods are delivered and paid for. In the second quarter of 1958, new orders for procurement and production of major defense items reached an annual rate of $24.3 billion, nearly triple the low rate in the pre-Sputnik third quarter of 1957. Such orders are scheduled to recede from the second quarter rate during fiscal 1959, but the annual total is expected to be about a billion dollars higher than the fiscal '58 total of $16.8 billion. Orders exceeded expenditures for these goods by $2.1 billion during fiscal '58, thus bolstering business backlogs.

Total federal expenditures for goods and services (excluding financial transactions such as interest and transfer payments) are expected to rise to $54.5 billion in fiscal '59 from $51.0 billion in fiscal '58. In addition, state and local government spending on public works is scheduled to increase further in the year ahead.

Capital Investment Outlook Brighter

Strength in construction has been a fourth factor pulling the economy out of the rut, thanks mainly to recovery in residential construction and enlarged spending for public works – roads, schools, and similar projects. Stimulated by easier credit conditions during the early part of the year and by other Government measures to promote home building, the number of private housing units started rose from a seasonally adjusted annual rate of 915,000 during the winter to 1,170,000 at the August peak, the highest in two and a half years.

The principal weak areas, tending to hold down the total, have been in commercial and industrial building. Hence the special importance attached to the latest quarterly Commerce Department-SEC survey of business spending on plant and equipment taken in mid-August. At that time, businessmen reported that they planned to hold capital expenditures in the third quarter approximately level with the second quarter on a seasonally adjusted basis.

Whether the upturn in plant and equipment outlays actually takes place in the fourth quarter or is deferred until early 1959 is less important than the indication that virtually all of the decline in heavy equipment and industrial construction has already taken place. This evidence of bottoming out is supported by an irregular but decisive uptrend in new orders for nonelectrical machinery reported by McGraw-Hill and the finding of the Federal Reserve Board that production increases since early spring ". . . have included advances in industries producing capital equipment. The rise in equipment industries is in contrast to continued declines after the total index had reached its low in the two earlier postwar recessions."

The decision to invest in new plant and equipment is a businessman's most convincing vote of confidence in the economic outlook. His willingness to risk capital on new facilities implies the belief that when they are completed there will be a profitable market for the additional production. The existence of substantial unused capacity in many lines had been considered a deterrent to further expansion until mid-1959 or later. Now it appears that this influence is being offset by the desire to modernize, cut costs, and provide facilities for new products. Inflationary psychology – fear that waiting will only mean

higher costs — has also entered into the calculations.

Expansion of capacity is often a by-product of modernization. The steel industry, which averaged 54 per cent of capacity during the first half year, certainly felt no need for further expansion as such. Yet in 1958, according to *Steel*, a total of 6.3 million tons will have been added to capacity, an increase of over 4 per cent, largely as a result of improving the operating efficiency of present facilities.

Bolstering the feeling of general economic confidence has been an improved flow of profits in many lines of business. The Securities and Exchange Commission reports that, in the second quarter of this year, corporate profits after taxes for all manufacturing corporations advanced 15 per cent over the first quarter — the first increase since the end of 1956. Profits as a per cent of sales rose from 3.4 to 3.8 per cent. As operating rates rise further, efforts of businessmen to reduce costs will show up more in the profits figures.

Lagging Employment

The broad trend of the recovery has not yet brought with it comparable gains in employment.

Factories increased production 9 per cent between April and August on a seasonally adjusted basis, but they added only 1 per cent to the number of production workers. Even allowing for increased working hours, the gain in man-hours was only 3 per cent, implying a reduction in unit labor costs. The tendency for production to rise faster than employment is typical in the early stages of recovery as the slack and inefficiencies of low rates of operation are eliminated and efforts to save on labor and other costs begin to pay off.

This lag in reemployment emphasizes that full recovery is still some distance off. Until unemployment insurance and other government benefits are replaced to a greater extent by individual earnings, buying power will not be on a firm basis. Few people buy new cars from their unemployment insurance checks.

The existence of substantial unemployment (4.7 million at the latest count) is a symptom of soft spots persisting in the economy and argues against taking too rosy a view of the outlook. Moreover, the extent to which investor and business decisions are being influenced by fear of inflation is an unwholesome and unstable feature of the situation.

Financing the Deficit

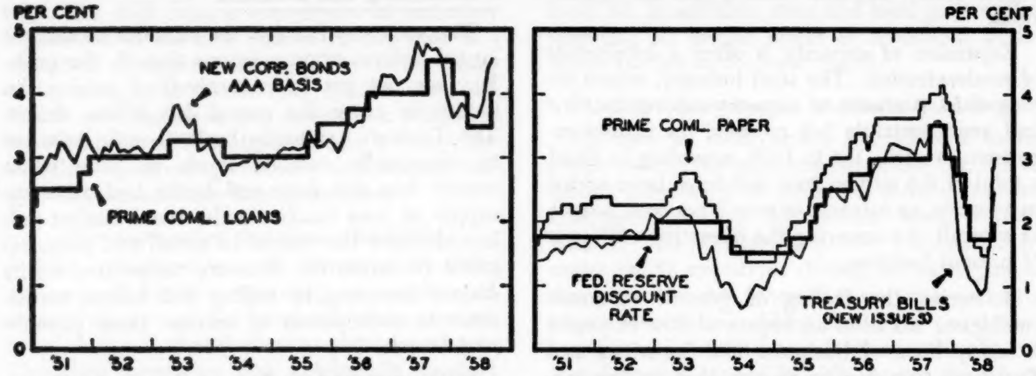
The economy has felt the stimulus of the enlarged federal appropriations though the problem has not yet been resolved of raising the money to cover the record $12 billion deficit. The Treasury prudently built its cash balances to abnormally swollen levels in June when money was still easy and banks had an oversupply of loan funds. As the bond market collapsed under the weight of actual and potential credit demands, the Treasury temporized on its August financing by selling $3.5 billion certificates in anticipation of income taxes payable next March.

With continued weakness in bonds, the Treasury had little choice but temporizing further on its October financing, announced after the close of business September 25. The Treasury offered for sale September 29 $2.5 billion 219-day special bills dated October 8 and due May 15, 1959 at a set price of 98.023 to yield 3¼ per cent, and $1 billion 13-month 3½ per cent notes dated October 10 and due November 15, 1959.

The chart following brings out the sudden reversal of money rates which followed the business upturn, the disclosure of a $12 billion federal deficit, and the turn of Federal Reserve policy toward restraint on inflationary psychology. While the Federal Reserve discount rate remains at a modest 2 per cent, up only ¼ per cent, yields on 91-day Treasury bills are pressing beyond 2½ per cent as compared to a low in June below ¾ per cent and a 1957 high of 3⅝ per cent.

At the long end of the market new corporate bond issues, Aaa-rated basis, were placed in September at an average rate of 4.56 per cent, within ¼ per cent of the 1957 peak. Yields on long-term U.S. bonds (not shown on the chart) have risen practically to their 1957 peak level.

This movement in bond yields is a reflection of unexpectedly heavy demands for funds from the home-building industry, corporations, states and municipalities, and foreign borrowers. It is all the more striking since the U.S. Treasury has made no attempt to raise money at long term since $1.1 billion 27-year bonds were sold at 3.22 per cent in June. The Treasury has been hoping for a restabilization of the bond market to permit financing of at least some part of the deficit in the long-term investment market. Unfortunately — though not unnaturally — the unmanageable federal deficit has made many investors wary of long-term bond investments at the very same time that it leads other borrowers to hurry and get in ahead of potential Treasury offerings.



High Grade New Corporate Bond Yield and Commercial Bank Prime Loan Rate; Federal Reserve Bank of New York Discount Rate, Treasury Bill Rate, and Prime Open Market Commercial Paper Rate

Bank Underwriting

The new securities were generously priced in an effort to overcome the resistance of buyers who have lost heavily on purchases of previous issues and who not unnaturally fear further market price depreciation as excessive credit demands collide with a Federal Reserve policy of resisting inflation.

There are never outright buyers on any single day for multi-billion-dollar government security issues. The securities were designed to be taken in the first instance by commercial banks, to be carried if necessary against borrowings from the Federal Reserve Banks, for redistribution as demands develop from corporations and other short-term investors. The spread of the new issue rates over the 2 per cent Federal Reserve discount rate – 1¼ and 1½ per cent respectively – makes it profitable for banks to buy and carry the new securities against borrowings from the Federal Reserve although it is freely recognized that discount rates are quite likely to be further advanced, that the discount facility in any case is given only for temporary accommodation, and that losses might be involved on resale as has happened with such distressing frequency on other issues.

While some banks and others entered subscriptions against surplus investment funds, it was more common for subscribers to plan unloading as rapidly as satisfactory bids appeared with the thought of freeing funds either for use in meeting customer loan demands or giving an assist on successive further Treasury cash financing offers that loom in the months ahead.

Even though the short-term securities can be largely redistributed outside the banks, the unpleasant fact remains that the Federal Government, in financing with 1959 maturities, is building up the volume of refinancing required next year. Whoever has them, short-dated Treasury obligations provide an escape hatch for the holder from Federal Reserve efforts to restrain spending and lending. He can demand cash at maturity.

An Unfinished Business

While appropriating on a vast scale and authorizing the Treasury to borrow within a newly-raised $288 billion public debt limit, the Congress took no measures to make U.S. bonds more readily salable in larger amounts. It was assumed, seemingly, either that the deficit should be financed with inflationary short-term borrowings or that people would come forward to purchase more bonds without special inducements.

The hard fact is that the very profligacy of expenditures has hurt the market, frightening off into inflation hedges many buyers who sense an oversupply of U.S. securities – and depreciation of the dollar – for an indefinite period to come. It will only impair confidence further if the new Congress next January attacks the Treasury and Federal Reserve for manifest difficulties in financing the deficit. The dedicated men of these agencies are simply doing the best they can in a trying situation.

U.S. securities can be made sufficiently attractive to divert into federal coffers savings now going into home mortgages, corporate bonds and stocks, and state and municipal obligations. But the better solution is to let home, business and school financing go forward and retrench federal expenditures.

As Treasury Secretary Robert B. Anderson told the annual convention of the American Bankers Association a week ago: "The time for a showdown with inflation is now." This can only be accomplished by a Congress willing to face fiscal facts.

A Budget Out of Control

Dominated by concern over Russian advances and the economic recession in this country, Congressional actions on the President's budget requests for the fiscal year ending June 30, 1959 have produced record peacetime spending. At the same time the decline in business profits has cut the revenue flow. Thus, the Budget Bureau's September review puts the fiscal '59 federal deficit at $12.2 billion, compared with $2.8 billion in fiscal '58 and a surplus of $1.6 billion in fiscal '57. On the "cash basis," which includes income and outgo of the old-age, unemployment and other government trust funds, the deficit is figured at no less than $13.7 billion. Against this background, hopes of a year ago for long postponed income tax rate reductions have all but vanished. In their place are fears of inflation and tax increases.

As the following table shows, federal expenditures within the regular budget are now projected at $79.2 billion in fiscal '59. Receipts are figured at $67.0 billion. These estimates assume continuation of the business recovery. The expected deficit would widen if business should falter again. On the other hand, it would narrow if the recovery should progress faster than expected by the Treasury's statisticians. But a return to a balanced budget will largely depend, as Budget Director Maurice H. Stans has pointed out, on "restraint in new demands on the Government" and public support for "gradual reductions in some programs."

Federal Government Expenditures and Receipts

(In Billions of Dollars)

		Change from		
	Fiscal '59 Sept. est.	Fiscal '59 Jan. est.	Fiscal '58 Actual	Fiscal '57 Actual
Expenditures	$79.2	+ 5.8	+7.8	+ 9.8
Receipts	67.0	— 7.4	—2.1	— 4.0
Deficit	$12.2	+12.7	+9.4	+18.8

Contrary to widespread impressions, the $12.2 billion budget deficit reflects bigger spending much more than recession-caused shortfalls in receipts. While revenues are now estimated $7.4 billion lower than they were in January, this is a comparison with figures which optimistically presumed a sizable increase to a level never before attained. When the comparison is made with actual 1958 results, the latest estimates for '59 show a $7.3 billion rise in spending while revenues are down only $2.1 billion.

Advocates of bigger federal spending as the answer to the business recession may argue that the rise in expenditures and in the deficit were necessary and effective in stimulating the business upturn. But many observers are beginning to recognize that the Congress, after deciding against tax reforms as a support to recovery, became overenthusiastic in seeking out new ways to spend more money. This has created a situation where stable prosperity is menaced on the one hand by inflation and on the other hand by threats of higher taxes or governmental controls to repress the inflationary forces set loose.

Nondefense Spending Splurge

While the initial impetus to spending psychology came from the threat of Russian Sputniks and missiles, only $2.0 billion of the $7.3 billion scheduled rise in federal expenditures over fiscal '58 is accounted for by National Security and International Affairs and Finance, which together make up President Eisenhower's category of "protection" or national defense.

National Security outlays are up $1.9 billion, reflecting higher spending on missiles, military research and development and the Atomic Energy Commission.

Outlays for International Affairs and Finance, largely devoted to strengthening allied and neutral nations abroad through economic aid and Export-Import Bank loans, are slated to rise $92 million to $1.4 billion. While there have recently been a series of proposals for an Arab "development bank," a Latin American "development bank," increased contributions to the International Monetary Fund and World Bank, and a new International Development Bank to make "soft" loans to nations otherwise unable to borrow, these are not yet provided for in the budget.

Thus, the jump in fiscal '59 spending must be laid to a surge in nondefense outlays, now figured to rise $5.3 billion or 21 per cent to a new high of $30.9 billion. As the table below shows, with the exception of interest on the public debt, every major nondefense spending category will require more money than in fiscal '58. (While a rising public debt naturally brings an increase in the interest item, something is being saved as a result of the refundings accomplished by the Treasury earlier this year at relatively low rates.)

Federal Budget Expenditures by Major Programs
Fiscal Year 1959

(In Millions of Dollars)

		Change From	
	Fiscal '59 Current est.	Fiscal '59 Jan. est.	Fiscal '58 Actual
Major National Security	$46,845	+ $509	+$1,888
Internat'l Affairs & Finance	1,441	+ 129	+ 92
Veterans' Services & Benefits	5,162	+ 150	+ 186
Labor & Welfare	4,845	+ 702	+ 964
Agriculture	6,392	+ 1,791	+ 1,917
Natural Resources	1,691	+ 199	+ 148
Commerce & Housing	3,878	+ 2,091	+ 1,763
General Government	1,667	+ 264	+ 811
Interest	7,573	— 291	— 117
Allowance for Contingencies			
Pay Adjustment	—	— 179	
Other	225	— 75	+ 225
Total	$79,228	+$5,289	+$7,326

The biggest nondefense increase—a $1.9 billion rise to a new high of $6.4 billion for Agriculture—was largely beyond Congress' control. It stemmed from the impact of extraordinarily large wheat and feed grain crops on agricultural price support programs.

Another influence for bigger spending—the approximately $1.4 billion total of military and civilian pay increases voted by the 85th Congress—is scattered throughout the budget. While Congress recognized that the pay boosts would stimulate the economy the primary purpose was to help Government employes keep up with the rising cost of living.

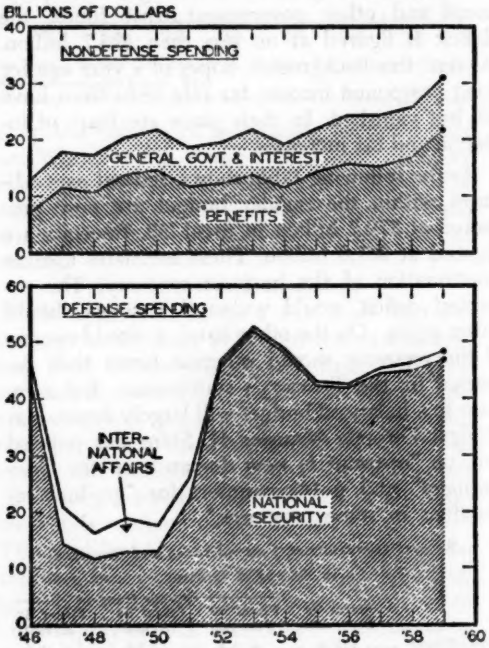
Expenditures aimed directly at fighting the recession total about $2 billion and are concentrated mainly under the headings Commerce and Housing, Labor and Welfare and Natural Resources. Approximately $1.3 billion of the $1.8 billion rise in Commerce and Housing outlays to a record $3.9 billion reflects Federal National Mortgage Association mortgage purchases to stimulate home building and the extension of the veterans' housing loan program. About half of the $964 million increase in Labor and Welfare spending, to a new peak of $4.3 billion, stems from federally financed extensions of state unemployment insurance benefits. The $148 million rise to a new high of $1.7 billion for spending on Natural Resources is financing an acceleration of public works.

It is not hard to understand why Congress went along with the expansion of nondefense spending. In the recession atmosphere long-standing pleas for new or expanded federal spending programs had the additional merit of "putting money into circulation." At the same time, with state and local tax receipts suffering from the recession, people turned to the Federal Government for help on school and other local problems, ignoring for the time being traditional fears that federal aid would mean federal domination. In the background was a feeling that if the U.S. Government can spend money abroad to make and keep friends and promote trade and intercourse among the nations, it can certainly afford to expand domestic aid programs for its own citizens.

A Persistent Drift

What needs recognition is that nondefense spending has become the core of the budget problem. There is always a case to be made for adding and expanding federal programs. But pursuance of this policy has led to an accelerating rise in spending since 1954. The problem is aggravated now because we no longer have the cutbacks in defense spending which helped conceal increases in nondefense outlays during the 1954-56 fiscal years.

The chart below compares, over the years since 1946, the trend of spending for defense and nondefense programs. It brings out how much of the increase in nondefense spending reflects the expansion of "Benefits" for the people. "Benefits" are defined as the total of expenditures under programs for Veterans, Agriculture, Natural Resources, Labor and Welfare and Commerce and Housing. Along with General Government and Interest on the public debt they make up total nondefense spending.



Federal Budget Expenditures, Fiscal Years ended June 30, 1946 - 59

It is a striking fact, in light of constant references to national defense as the cause of high and rising budgets, that projected outlays for National Security and International Affairs in fiscal '59 are still $4.3 billion below their $52.6 billion peak in fiscal '53.

Nondefense outlays, on the other hand, are now projected at $30.9 billion, no less than $9.2 billion or 42 per cent above their $21.7 billion fiscal '53 level. Increases in General Government and Interest outlays account for only about $1 billion of the rise. It is the tendency of the people to demand more and more from Government that has been pushing the federal budget up and up.

In State and local affairs, people are conscious that increased benefits bring increased tax burdens. New schools or hospitals generally are

approved only after careful consideration. Federal money "for free" often seems an easy way out. But of course it is not free. Its cost must be measured in lost opportunities for tax reforms and in price inflation.

Congressman Leon Gavin of Pennsylvania warned in the closing days of the last session of Congress:

. . . the Government today is becoming a Government of pressure groups – in fact, a Government of subsidies. We subsidize many and varied programs – from agriculture to minerals we are creating a utopia where no one can lose. The Government will protect and finance all phases of our economic and social life. We may go bankrupt and create chaos; however, these programs must go on.

• • •

Certainly we did not build our country on subsidy programs. America was built by hard work, thrift and frugality.

• • •

Unless we change the trend I am quite certain we will end up with a bureaucratic Government overlording all phases of our economic and industrial life.

And Congressman Keith Thomson of Wyoming concluded:

To meet this situation, we, as Members of Congress, must evidence "backbone" instead of "wishbone". Really what is most required is for individual Americans to realize what is being done "to them" instead of "for them".

Sober Second Thoughts

What ended the Congressional spending spree was the public debt limit, despite the fact that it is often criticized as meaningless since Congress can change the figure whenever it pleases. Last February Treasury Secretary Robert B. Anderson requested and was granted a temporary $5 billion increase to $280 billion to cover the fiscal '58 deficit. In August, Secretary Anderson not only came back for a bigger increase to take account of the '59 deficit but also suggested that still another boost might be needed next year. While a further increase to $288 billion until next June 30 was granted, the rapid succession of debt limit increases brought home to Congress for the first time how far it had gone in authorizing deficit spending. At the same time, weakening prices for government bonds indicated a reluctance of the American people to lend to the Government.

It was in this situation that Congress changed its attitude towards spending. Congressman Leo Allen of Illinois called the bill to increase the public debt limit "a very unpleasant bill, one of the most unpleasant bills that has been before the House since I have been a Member of Congress."

The President last spring forecast an early business upturn and the emergence of increased federal spending as an inflationary danger. Both anticipations proved true. It should not be surprising that inflation psychology has emerged as a major threat to economic stability.

Congressman John Byrnes of Wisconsin recognized Congress' responsibility:

The situation we are facing today, and the cause of it, is no secret. A majority of the Congress has gone wild in authorizing and appropriating for new and increased expenditures and it is going to do you no good to blame the Executive or anybody else. The Executive cannot spend 1 cent that this Congress does not authorize and appropriate.

A more sober attitude became apparent in the closing hours of the 85th Congress when the House rejected a $2 billion program of 50-year federal loans to local communities, failed to act on a $2.4 billion omnibus housing bill, and rejected a $650 million program to stabilize prices of copper, lead, zinc, and other minerals.

As Vice President Richard M. Nixon told the 50th Anniversary Conference of the Harvard Business School last month: "The twelve billion dollar deficit in the current federal budget is a major inflationary factor. We must learn that we cannot add new programs to the federal budget unless we are prepared to levy the taxes to pay for them."

Inflation and the Budget

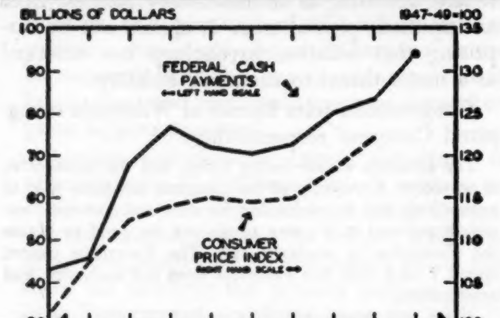
Congressman Clarence Cannon, Chairman of the House Appropriations Committee, gave a forthright appraisal of the 85th Congress' record in a pointed reminder to his fellow legislators:

When you go home at the close of the session and your people complain about the high cost of living, do not pass the buck. Tell them the facts. Tell them the national debt is higher because you voted to make it higher. Tell them the dollar has gone down and the cost of groceries has gone up because you voted to depreciate the dollar and voted to raise prices.

Not everyone would link federal spending and inflation so closely. People remember that big budgets and deficits in the 1930's had limited effect on prices until the massive spending of World War II ignited the inflationary fuel that had been spread around years earlier. When World War II ended government spending came down, but prices continued to rise as consumers poured wartime accumulations of savings into the markets to buy new homes, cars, and appliances.

Since 1950, the cost of living and federal cash outlays have shown a clear tendency to move together, as the chart on the next page shows.

The consumer price index eased 0.2 of a point to 123.7 in August, its first decline in two years. It may be that declining food prices in the year ahead, growing out of abundant crops, will hold



Federal Cash Payments and the Consumer Price Index
Fiscal Years ended June 30, 1950 - 59

back the cost of living in the face of the new peak in federal cash outlays. But this can be only a temporary influence if a check is not placed on government expenditures. The option of levying taxes, ironically, would likely put additional upward pressure on prices and wage demands.

Congressman Wilbur D. Mills, Chairman of the House Ways and Means Committee, fears that the budget:

> . . . could let loose inflationary pressures that in turn will be emulated by business and labor. The result could be that during the course of the next several years we will see rises in prices such as we have not seen in peacetime.

In the words of Congressman Byrnes of Wisconsin:

> . . . this fiscal situation is beyond the point where it can be brushed off lightly. It is time, if this economy of ours, if our whole political system is to survive, that Members of Congress demonstrate the highest order of statesmanship in meeting these issues.

A New Retrenchment?

President Eisenhower gave a strong lead for a return to economy in his August 28 press conference. He stressed that his first objective is:

> . . . getting down these deficits and keeping our money sound so that America can have a good, healthy, thriving, progressive economy.
>
> . . . I am going to take each one of the major expenditures, study it and see whether it can be, to the benefit of America, diminished.

Emphasizing the firmness of his purpose the President vetoed a $280 million 4-year program of federal aid to depressed areas, a $437 million bill expanding federal aid for airport construction over the next four years, and rejected Congressional attempts to vote $589 million he had not requested to the Civil Service retirement fund.

On September 10, Budget Director Stans, acting on President Eisenhower's orders, sent a letter to the heads of all government agencies directing them to make a 2 per cent reduction in the 2.4 million federal work force by leaving vacancies unfilled and avoiding the creation of new positions. This could save about $200 million a year.

On September 11, when the revised fiscal '59 budget estimates were released the Administration revealed that it would freeze $1,170 million in defense funds that Congress had voted above the President's requests. The decision does not deny essential needs but courageously backs up Defense Secretary Neil H. McElroy's contention that: "There is a point, however, beyond which gambling huge sums on untried weapons would be foolhardy—would, in fact, endanger the economic, and even the military, security of the country."

The next step the Pentagon wants to take—an even harder one—is to curtail or eliminate duplicate airplane and missile development and production programs which have been tried and found wanting. This is essential if we want to concentrate on the most effective weapons but, according to *The New York Times*, the task is being "tremendously complicated by political and economic factors and by pressure groups. Aircraft and missile manufacturers and politicians from the areas concerned by possible contract cancellations or closing of defense installations already have brought great pressure upon the Pentagon and the Administration . . ."

It will take all that the President and Congress can do to keep federal spending in check.

The renewed concern in Washington about the upward trend of spending is a good omen. In fiscal '53-55, when there was determination to get federal taxes down, the budget was cut from $74.3 billion to $64.6 billion. It was in the years following '55, when zeal for economy lessened, that the upturn in spending was renewed.

The goal of a new retrenchment is worth the effort: money that people can trust, a sound federal fiscal structure, an honest tax system, and an economy prepared for any eventuality. Indeed, if we are to face up to the responsibilities of world leadership there is no alternative.

Full Employment and Stable Money—A British View

Responsibility for the protracted currency disorders that have plagued the Western world for almost a quarter of a century lies basically in the determined and persistent attempts on the part of people and governments to spend in excess of what is being produced.

The main factors behind this continuing crisis of our times have been analyzed this year in two reports by the British Council on Prices, Productivity, and Incomes – the Cohen Council. Although dealing with specific conditions and problems of Great Britain, they contain much that applies to other countries, including the United States. Most important, the Council takes on the problem of how a nation can make maximum use of its labor force while at the same time preserving the value of its currency.

The twin goals of full employment and stable money have proved elusive – here as well as abroad. Nations have been successful in maintaining conditions in which jobs are abundant, but they have failed to prevent rising prices.

In this country there are some, like Professor Sumner Slichter of Harvard, who believe that the two goals are incompatible. Labor unions will make full use of the bargaining powers that full employment confers on them to force wages up faster than gains in labor productivity and thus push up costs and prices. On the other hand, Arthur F. Burns, President of the National Bureau of Economic Research, believes that "reasonably" full employment and "reasonably" stable prices can be reconciled.

Whoever proves to be right, the issue promises to continue to be a critical one – the subject of much private research and study and of considerable concern to the Administration as well as to the Congress. Thus, the Committee for Economic Development's recently formed National Commission on Money and Credit will consider, as part of its broad inquiry, whether the objectives of economic growth, sustained high employment and production, and prevention of steadily advancing prices "are consistent with one another."

Treasury Secretary Anderson stressed late last month that, while the Government does have a responsibility to provide "maximum employment," it is equally important that "we accept . . . the principle of the integrity of money." The most recent indication of Congressional interest in the problem is the announcement in mid-September that a House-Senate Economic Subcommittee, headed by Congressman Wright Patman of Texas, is canvassing some 1,500 university economists as to whether maximum employment and price stability can be maintained "and, if not, which should have priority."

The Cohen Council

It is doubtful if any simple count of ballots can settle the question. Economists who have studied the matter express innumerable shades of view. In any case, a better approach is to give the task to a council of experienced, judicious men with time to ponder, exchange views, and reach a common judgment.

The Cohen Council was appointed by the British Government in August 1957 "to keep under review changes in prices, productivity, and the level of incomes (including wages, salaries, and profits) and to report thereon from time to time."

It has as its Chairman Lord Cohen, a judge, who was the first Chairman of the Royal Commission on the Taxation of Profits. The other two members are Sir Harold Hewitt, a past president of the Institute of Chartered Accountants, and Sir Dennis Robertson, lately retired professor of political economy at Cambridge University.

In its first report, published last February, the Council dealt with postwar inflation generally. The second report, issued in August, concentrates on trends in prices, productivity, and incomes this year. It concludes that the dangers of inflation still exist and that the Government should therefore exercise caution in embarking upon an expansionist monetary policy.

The Council has incurred the disapproval of the labor unions and the Labor Party. In general, however, its reports are widely regarded as a sober analysis of some of the most urgent and disquieting problems that Britain faces today.

Diagnosis of Economic Ills

In reviewing the factors behind the postwar inflation, the Council found in its first report that the main cause was "an abnormally high level of demand for goods and services in general, maintained for an abnormally long stretch of time." This seemingly intractable demand was assisted above all by two circumstances – excessive liquidity associated with monetary ease during much of the postwar period, and the Government's commitment to "full employment." This commitment not only influenced the rise of government expenditures, but was taken by business men "as a signal that there would be no general drying up of the demand for their products." The high level of world demand, itself largely a reflection of "full employment" policies in other countries, further increased the pressures in an export economy like Britain's.

In this environment of buoyant demand and monetary expansion, wages were continually pushed up. The Council emphasized, however, that a necessary condition for successful demands for higher wages (or increases in other incomes) is that employers have the financial means to pay them and are thus able to maintain the pressure of their demand for labor. Wages and prices cannot be restrained, and industrial efficiency can-

not be maintained, if there are more job openings than job seekers.

For these and other reasons, the Council noted last February that Britain ought not be concerned about a check to production that would necessarily follow "damping down of demand":

. . . Excessive demand cannot be restrained if at the same time it is sought to wring the last ounce of output out of a given constellation of human and material resources. In an over-extended economy it is to be expected that a moderate contraction of demand will tend to eliminate the most costly units of output, thus diminishing the total flow of money incomes by more than it diminishes the total flow of output, which is, of course, from the "disinflationary" standpoint, the right result. . . .

But further there seems every reason to hope that by facilitating a smoother flow of work and a better organization of labour, and transmitting a pressure towards greater efficiency of management, the less congested condition of demand will also bring it about that the loss of output proves to be no more than temporary. . . .

"Inflation Not Killed"

The measures to dampen down demand taken by the British authorities in September 1957, under the pressure of a sterling crisis that threatened exhaustion of its international reserves, included an increase in the official discount rate to 7 per cent — the highest since 1921, the establishment of ceilings on commercial bank advances, a further tightening of controls over new capital issues, and cuts in government outlays.

These restrictive measures worked well, according to the second Cohen report. First, restrictions on home demand tended to reduce imports and encourage exports and helped to restore foreign confidence in the pound, which brought about a sharp improvement in Britain's gold and dollar reserves. Second, there was an improvement at home — "though a less definite one" — as the rise in retail prices subsided. And third, incomes were rising more slowly.

The report concedes that national output has increased but little, and industrial production has fallen slightly; there has also been a small rise in unemployment. But the gains from the restrictive monetary policy — a stronger balance of payments and a better trend in prices — are greater than the cost of some rise in unemployment and a check to production. "Our general judgment, in short, is that the policies of damping down demand have worked to an extent that fully justifies their adoption."

Today the British economy is working somewhat below its productive capacity; and the authorities have taken a number of measures to encourage a revival of demand, including reductions in the discount rate to 4½ per cent, a loosening of controls over commercial bank credit and capital issues, and a lifting of the ceilings placed on commercial bank loans. But, in the Council's opinion, the degree to which demand can be raised without running into bottlenecks and raising labor costs is quite small.

The second report sums up:

The dangers of inflation have only been scotched, not killed, by the slackening of tempo in the last twelve months. We must not suppose that we have solved the problem of getting the growth of incomes into line with that of productivity, merely because in the year 1958 increases in income look like being distinctly lower than in previous years.

Our balance of payments is in a healthy state, and our foreign exchange reserves have been rising very satisfactorily: but neither of these conditions is bound to last. Past experience suggests that any substantial revival of demand may well be accompanied by renewed threats to price stability to the balance of payments and the gold and dollar reserves.

The Longer View

Looking farther ahead, the Council squarely faces the basic issue arising "from the conflict of two main objectives of economic policy — full utilization of the national resources of labour and capital, on the one hand, and stable prices on the other."

Throughout the postwar years, Britain has experienced "over-employment" — more jobs than workers to fill them. British unemployment has averaged less than 2 per cent of the labor force (as against more than 4 per cent in the U.S.). It has also suffered a serious inflation: in the decade 1947-57, the pound sterling lost internal buying power at a compound annual rate of 4.7 per cent. Interest rates required to attract buyers of government bonds naturally have risen sharply.

The Cohen Council found that the Government "cannot afford" to allow the pressure of demand for goods and for labor to "rise to the peak levels of the past if it wishes to avert price inflation."

Noting that this advice will remain valid "for as far ahead as it is useful to look," it went on to observe that if peak levels of demand are avoided "it can hardly be expected that the average level of unemployment over a period of years will be quite so low as in the last decade."

The problem of local concentrations of unemployment is likely to become "somewhat more serious" — all the more so since the direct cause of these pockets is often some change in the structure of industry, not itself connected with the level of over-all demand. The policy of "bringing work to the workers" has "definite limits" as long as the Government rules out "extravagantly wasteful methods."

Turning to wages and salaries, the Council emphasized that the relatively low level of increases — by some 3½ per cent so far this year — should be regarded as a stage in the process of getting the wage trend better into line with the trend of output per worker:

> . . . It would be very wrong to suppose that this was an exceptional year after which we could cheerfully return to the happy days when annual wage increases typically ran at the rate of 5 per cent, 6 per cent or 7 per cent. Indeed the contrary is the case: next year, such wage increases as are granted should be lower than this year's.
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> For annual increases in wages of 3½ per cent are not merely higher than the *present* rate of productivity increase: they are higher than any rate of productivity increase which can reasonably be forecast over any long period of future years. It is virtually certain that a continuance of wage increases on this scale year after year would lead to a resumption of price inflation.

This prospect is not, however, "so depressing as might at first appear." This year's wage increases have come after a period when retail prices were rising at the annual rate of more than 4½ per cent. Most of them therefore barely restored the real income of the workers and many of them fell short of it. A lack of full compensation is "a necessary first step" in the process of ending the slide in the value of money, the Council said, and added that there are "considerable advantages to be gained, even by the workers themselves, from accepting it."

The Council explained that this year real progress has been made in checking inflation, and next year wage negotiators are likely to look back on a period of more stable prices than heretofore. Any wage increase next year may be less, in money terms, than this year, and yet mean a real advance in workers' purchasing power for goods and services.

The second report also deals with profit margins and their impact on prices. If the pressure of demand is just enough to ensure high employment but not enough to cause widespread shortages of goods and services, experience suggests that no independent push toward an inflation of the general level of prices will come from the side of profits, according to the Council.

Lessons for the U.S.

The Cohen Council has done a remarkable job in helping clarify some of the crucial issues bearing on the problem of economic re-expansion consistent with reasonable price stability. Among these issues, three call for particularly close attention at this juncture:

First, with the productive capacity of the economy somewhat underemployed, it is right that policy should aim at an expansion of demand, but

> . . . it must proceed gradually and with caution towards that end. The dangers of recession are not so drastic and so imminent, nor those of inflation so remote, as to justify a policy of all-out encouragement of expenditure.

Second, even if a re-emergence of the pressure of demand equal to that of the earlier years is effectively prevented, it will be necessary to restrain wages in order to ensure over-all price stability. The reason for this is that the growth of productivity varies among different lines of production. If firms and industries in which the growth of productivity is slower should increase wages and other incomes as much as those where the growth is faster, there would be a continuing tendency for costs and prices to rise. It is essential, therefore, that the growth of productivity in the rapidly progressing industries should yield lower prices for the benefit of consumers as well as higher wages for the workers employed.

And, finally, the objective should be to stop inflation, not merely moderate its course. Rejecting the idea of a 2 or 3 per cent annual increase in the price level, along with all schemes for "protection" against this rise — e.g., tying wages, salaries, pensions, and loans to a cost of living index — the Council stated in its first report:

> At the best, the operation of a double standard of value of this kind would be a cumbrous and inefficient way of conducting affairs. But the most important result is likely to be that the upward movement of prices would cease to be slow.
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> At present the groups which are in a strong strategic position derive gains corresponding to the losses of the weaker groups. As the losses were diminished, the attempt to preserve the gains would tend to speed up the whole inflationary process. The final result might well be a situation so disastrous that a remedy would have to be sought at all costs, including perhaps heavy unemployment and distress.

In other words, there is no choice between full employment and stable prices, but only a choice between stable prices and accelerated inflation jeopardizing the security of everyone.

As Federal Reserve Board Governor M. S. Szymczak noted in a speech before the Washington chapter of the National Association of Accountants September 17:

> The hardest, most tragic way to prove the folly of the notion that there can be any such thing as "permanent inflation" is to let a little inflation snowball into a big one that must in time collapse with consequences heavy in human hardship.
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> The . . . more sensible way is to pursue a course that will make for a sound, stable dollar, and thus overcome expectations of inflation by demonstrating they are groundless.

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